



ADVISOR GUIDE

IRC § 101(j)

AVOIDING POTENTIAL TAXATION OF
EMPLOYER-OWNED LIFE INSURANCE



Whether you call it § 101(j), COLI best practices, EOLI requirements, or the PPA rules, there is a law that has the potential to create negative income tax consequences for your business clients. With the enactment of IRC § 101(j), the tax treatment for life insurance owned by a business has changed. Death benefits on policies insuring employees of a business will be taxed as income unless the rules are followed. And since § 101(j) applies to all policies purchased on or after August 17, 2006, as well as to material modifications of policies purchased prior to that date, there may be good reason to get educated.

SUMMARY OF IRC § 101(J)

Section 101(j) was enacted as part of the Pension Protection Act (“PPA”) which was signed into law on August 17, 2006. Under § 101(j), where the owner of a life insurance policy is a business and where the insured is an employee of the business, death benefits received by the employer may be excluded from gross income so long as two conditions are met: (i) the policy is held on an appropriate insured; and (ii) the employer satisfies all of the disclosure and consent requirements. Where both of these conditions are met, death benefits from employer-owned life insurance (“EOLI”) policies will continue to be excluded from the gross income of the business.

APPROPRIATE INSURED

In order for death benefits to be excluded from gross income, an EOLI policy must relate to an appropriate insured. An EOLI policy involves an appropriate insured if any of the following conditions is met:

- i. The insured was an employee at any time during the 12-month period prior to death;
- ii. The insured was a director of the corporation at the time the policy was issued;
- iii. The insured was a “highly compensated employee” (as defined in IRC § 414(q)) at the time the policy was issued;
- iv. The insured was among the highest paid 35% of employees at the time the policy was issued;
- v. The death benefit is used to pay benefits to the insured’s heirs, estate, or a trust for the benefit of one or more members of the insured’s family; or
- vi. The death benefit is used to purchase an equity interest in the corporation from the insured’s heirs, estate, or a trust for the benefit of one or more members of the insured’s family.

DISCLOSURE AND CONSENT REQUIREMENTS

In addition to meeting the proper insured requirements, a business must meet all of the following disclosure and consent requirements prior to issue of the EOLI policy:

- i. i. The employee must be notified in writing that the corporation intends to insure the employee’s life;
- ii. ii. The employee must be notified in writing of the maximum face amount for which the employer might insure the employee;
- iii. iii. The employee must be notified in writing that the corporation will be a beneficiary of some or all of the policy death benefits;
- iv. iv. The employee must give written consent to being insured by the corporation; and
- v. v. The employee must give written consent to coverage continuing after employment with the corporation is terminated.

It is important to make sure that insured employees are getting notices and providing consent to all of the specific requirements set out in § 101(j). While many insurance carriers provide consent forms as part of the insurance applications, it is unlikely that these forms will satisfy § 101(j). It is especially unlikely that the insurance carrier's standard consent forms will provide specific notice about the maximum amount of insurance that an employer might apply for or that there will be a provision regarding the possibility of coverage continuing after employment is terminated. A better practice may be to have employees sign an additional notice and consent form that is designed specifically for § 101(j) and have the business maintain those forms as part of its records. Finally, keep in mind that these notice and consent provisions also apply to policies on business owners if the owner is also an employee of the business.

In sum, an employer may receive death benefits which are excluded from gross income if the policy meets at least one of the appropriate insured or permissible use requirements and if prior to the policy's issue the corporation has complied with all of the disclosure and consent requirements. Generally, the "appropriate insured" requirement will not be difficult to satisfy for EOLI policies. So long as the policy is being used for key-person insurance, "top hat" plans, employee benefits, estate planning for a business owner, or to fund business buy-sell arrangements, the policy will be held on an appropriate insured. **What is challenging in § 101(j) are the disclosure and consent requirements. Agents and advisors must be diligent in helping business clients meet these requirements before a policy is issued.**

REPORTING REQUIREMENTS

In addition to § 101(j), the PPA added new reporting requirements for EOLI policies by enacting IRC § 6039I. Under this code section, a corporation which purchases life insurance on one or more of its employees after August 17, 2006 must report the following on an annual basis:

- The number of employees the corporation has at the end of the year;
- The number of those employees insured under EOLI policies at the end of the year;
- The total amount of EOLI insurance in force at the end of the year;
- The name, address, and taxpayer ID of the corporation and the type of business in which it is engaged; and
- A statement that the corporation has a valid consent for each insured employee (or the number of insured employees from whom consent has not been obtained).

In order to facilitate this reporting, the IRS has published Form 8925 which can be attached to the employer's annual income tax return.

REPAIRING NON-COMPLIANT EOLI ARRANGEMENTS

Section 101(j) can be an especially dangerous tax snare because all of its notice and consent provisions must be complied with before an EOLI policy is issued. What causes insurance agents to call the home office in a panic is the fact that many of them do not learn about § 101(j) until after the EOLI sale has been completed. **Is it too late?**

Unfortunately, § 101(j) fails to provide a remedy for failure to meet the notice and consent requirements before a policy is issued. But it seems unlikely that Congress meant for such a failure to be irreparable. After all, the purpose of § 101(j) is to prevent employers from insuring employees without their knowledge or consent. It seems that late notice and consent would be preferable to none at all. But without any remedy provisions in the statute, what can businesses do to fix a non-compliant EOLI arrangement?

UNDERSTANDING AND REPAIRING

While the IRS has yet to provide any specific procedure for correcting defective EOLI arrangements, it has issued some guidance in Notice 2009-48 (the “Notice”). A business owner seeking to repair an EOLI arrangement may want to consult with a tax advisor to see if one of the following remedies might work: (i) reissue, (ii) increase, or (iii) transfer.

Depending on how soon the parties recognize that there has been a failure to comply with § 101(j), it may be possible to have the underlying EOLI policy reissued by the insurance carrier. Under § 101(j)(4), the notice and consent provisions must be fulfilled before the policy is issued. According to section A-4 of the Notice, a policy’s issue date under § 101(j) is the later of (i) the date of application, (ii) the date coverage becomes effective, or (iii) the date of formal issuance. Thus, if the insurance carrier is willing and able to reissue the underlying EOLI contract, the parties may be able to meet the notice and consent requirements prior to the policy’s reissue date.

A second possibility for fixing a § 101(j) problem is to increase the death benefit on the EOLI policy. “[A]n employer-owned life insurance contract may be treated as a new contract, and thus newly “issued,” by reason of a material increase in death benefit or other material change in the contract.” Notice 2009-48, A-4. Although it is not clear how much of an increase in death benefit is needed to make it a material increase, section A-14 of the Notice indicates that any increase which is not required under IRC § 7702 or which is not merely administrative may be material. Clients would need to consult with their own tax or legal counsel to make this determination.

Finally, it may be possible to rectify a § 101(j) omission by transferring the EOLI policy to the insured employee and subsequently having the employee transfer the policy to the business. The IRS indicates in section A-8 of the Notice that: “The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death.” If the parties can work out a way to make these transfers income tax-neutral (i.e., avoid a transfer for value and not create any unwanted income for the employee), then a sequential set of policy transfers may be able to satisfy the requirements of § 101(j).

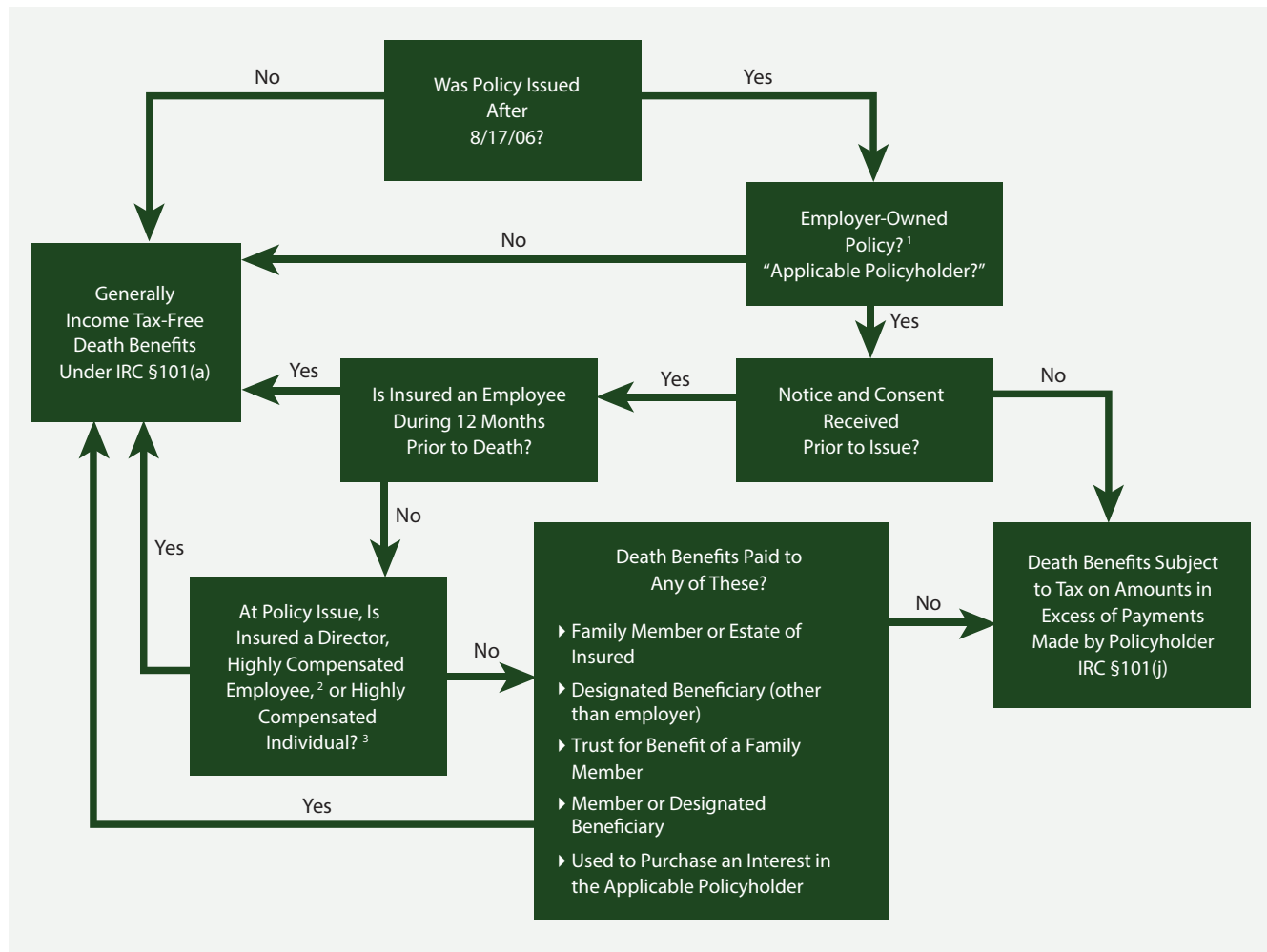
SUMMARY

Section 101(j) is a potential tax trap for any business purchasing life insurance on an employee or owner-employee. To avoid income taxation of death benefits, the insurance must be on an appropriate insured and all of § 101(j)’s notice and consent provisions must be met prior to issuance of the EOLI policy. Employers are also required to report EOLI holdings annually as part of the income tax return filed for the business. And while it may be difficult, business owners may want to consider strategies for amending defective EOLI arrangements to bring them into compliance with § 101(j).

FLOWCHART

EMPLOYER-OWNED LIFE INSURANCE CONTRACTS - POST AUGUST 17, 2006¹

This diagram gives you a quick overview of how to determine whether the death benefits will be subject to taxation.



1. The Pension Protection Act of 2006 defined an employer-owned life insurance contract as a policy owned by a person engaged in a trade or business (the “applicable policyholder”) under which such person, or a “related person” is directly or indirectly a beneficiary, and where the insured is an employee of the trade or business of the applicable policyholder on the date the policy is issued. Applicable policyholder includes a “related party”, which is defined as a person that bears a relationship described under IRC § 267(b), the constructive ownership rules; IRC § 707(b)(1), dealing with transactions between a partner and a partnership; and IRC § 52(a),(b), the common control rules applicable to corporations.
2. As defined under IRC § 414(q), includes employees who were 5% owners of the business during the preceding year or had compensation in excess of a specified dollar amount.
3. As defined under IRC § 105(h)(5), includes the five highest-paid officers and those individuals among the highest paid 35% of all employees.

IRS FORM 8925

Form 8925 (Rev. January 2010) Department of the Treasury Internal Revenue Service (99)		Report of Employer-Owned Life Insurance Contracts OMB No. 1545-2089 Attachment Sequence No. 160	
Name(s) shown on return		Identifying number	
Name of policyholder, if different from above		Identifying number, if different from above	
Type of business			
1	Enter the number of employees the policyholder had at the end of the tax year	1	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See Section 1035 exchanges on page 2 for an exception	2	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	3	
4a	Does the policyholder have a valid consent (see instructions) for each employee included on line 2? <input type="checkbox"/> Yes <input type="checkbox"/> No		
b	If "No," enter the number of employees included on line 2 for whom the policyholder does not have a valid consent		

SAMPLE NOTICE AND CONSENT FORM

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after August 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders must also indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received.

See sections 101(j) and 6039I, and Notice 2009-48, 2009-24 I.R.B. 1085, for more information.

Definitions

Employer-owned life insurance contract. For purposes of Form 8925, an insurance contract is an employer-owned life insurance contract if it is owned by a policyholder as defined below, and covers the life of the policyholder's employee(s) on the date the life insurance contract is issued. If you have master contracts, see section 101(j)(3) for additional information.

Policyholder. For purposes of Form 8925 and these instructions, a policyholder is an "applicable policyholder" as defined in section 101(j)(3)(B). Generally, a policyholder is the person who owns the employer-owned life insurance contract, and who is (a) engaged in a trade or business

that employs the person who is the beneficiary of the employer-owned life insurance contract.

Related person. A related person is (a) related to the policyholder (as defined in section 1361) or (b) engaged in a trade or business under common control with the policyholder. See section 1361(b)(1).

Employee. Employee includes an officer, director, or high-earning employee under section 501(c)(3). An individual who is a citizen or resident of the United States and is insured under an employer-owned life insurance contract. Because the contract covers two individuals, the insured.

Notice and consent requirements. For an employer-owned life insurance contract, the policyholder must meet the notice and consent requirements listed below.

1. Provide written notice to the employee stating the purpose of the contract and the maximum face amount of insurance that could be issued under the contract was issued to the employee.

The written notice must include a disclosure of the fact that the insurance, either in do multiple of salary, that

NOTICE AND CONSENT TO EMPLOYERS APPLICATION FOR LIFE INSURANCE

NAME AND ADDRESS OF CARRIER:

1. EMPLOYEE (PROPOSED INSURED) INFORMATION

Full Name (First, Middle, Last. Include maiden name in parentheses.)	Gender <input type="checkbox"/> F <input type="checkbox"/> M	Date of Birth MM/DD/CCYY	Social Security Number
Street Address	City	State	Zip Code
Occupation			

2. EMPLOYER (OWNER) INFORMATION

Full Legal Name

Street Address	City	State	Zip Code
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3. NOTICE BY EMPLOYER (OWNER)

- a. Employer intends to apply for insurance on the life of the Employee (Proposed Insured).
- b. The maximum face amount the Employee (Proposed Insured) could be insured for at the time the contract is issued is \$ _____.
- c. The Employer will be the Owner of any policy issued and a beneficiary of any proceeds payable upon the Employee's (Proposed Insured's) death.

4. CONSENT OF EMPLOYEE (PROPOSED INSURED)

- a. I consent to being an insured under the life insurance policy for which my Employer intends to apply.
- b. I consent to my Employer continuing coverage, after my employment ends, under any policy issued.
- c. I understand that my Employer will own the policy. Unless provided in a separate agreement, my Employer will receive all of the death proceeds, and my personal representative, next of kin, and heirs at law will have no beneficial interest in the policy or its death proceeds.

AGREEMENT AND AUTHORIZATION

This form is provided as a convenience to the Employer and to obtain information that may be needed for information reporting services. By providing this form, the carrier makes no representation that completing it will constitute compliance with any law or regulation, tax or otherwise. Federal tax law specifies that the death benefits of certain employer-owned life insurance contracts will not be completely excluded from federal gross income of the Employer unless notice-and-consent requirements and other requirements specified in the law are fulfilled.

The carrier and its representatives and distributors do not provide tax or legal advice. The carrier did not accept this form for use by any taxpayer to avoid any Internal Revenue Service penalty. You should ask your independent tax and legal advisors for advice based on your particular situation.

A photocopy of this form shall be as valid as the original.

Signature of Employee (Proposed Insured)	Date
Signature of Employer (Owner)	Date
Title	



CARRIER NOTICE AND CONSENT GRID

This grid is a guide to how various insurance companies handle the notice and consent requirement for employer-owned coverage

Carrier	Notice & Consent in Application	Supplemental Form	Notes	Form #
American General	No	No	No Consent on Application No Supplement Form Available	N/A N/A
Hartford	Yes	No	Had Employer-Owned Life Insurance Information Form end of Illustration No Employee Consent Form	N/A
Prudential	Yes	No	Sample Acknowledgment & Consent to Employer-Owner Life insurance in NB Application	Application NR-011078
Principal	Yes	Yes	Employee Consent Language in Application Employer or Employer Trust Owned -Consent to Be Insured	Application AA2000N SC Page 8 CC324-7
Penn Mutual	Yes	No	Consent Language on Application	Application M1143COM Page 12
Voya	No	No	No Consent Forms; No Language on App	N/A
Pacific Life	Yes	Yes	Proposed Insured's Consent on Application Employer Acknowledgement on Application Supplemental Form for Acknowledgement Regarding Potential Taxation of Death Benefits	Application 15-44772-02 Page 11 15-28623-02
Symetra	No	Yes	Has Notice and Participation Supplemental Form	LU-883
LFG	No	Yes	Supplemental Employee Consent Form	#LF06337
John Hancock	No	No	Agent Report has Questions on Employer Owned Policies No Employee Consent Form Sent Sample Consent Notice	NB6076US
AXA	No	Yes	Supplemental Forms	#141825/#137311
MetLife	No	Yes	Employer Owned Life Insurance Supplement Combined Employer and Employee Notice-Consent Acknowledgement	EOLI
Zurich	No	No	Generic Disclosure / Employer Owned Life Insurance and Consent Letter	

IMPORTANT DISCLOSURE INFORMATION

Content provided by Prudential and Voya. See original documents for important disclosures.

These materials are not intended to and cannot be used to avoid tax penalties and they were prepared to support the promotion or marketing of the matters addressed in this document. Each taxpayer should seek advice from an independent tax adviser. TDC Life and their agents and representatives do not give tax or legal advice.

TDC Life and their agents and representatives do not give tax or legal advice. This information is general in nature and not comprehensive, the applicable laws change frequently and the strategies suggested may not be suitable for everyone. Clients should seek advice from their tax and legal advisors regarding their individual situation.

Death proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from estate tax.

Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).

For policies issued after August 17, 2006, IRC § 101(j) provides that death benefits from an "employer-owned life insurance contract" are income taxable in excess of premiums paid unless an exception applies and certain notice and consent requirements are met before the policy is issued. Please consult your tax or legal advisors for more information. Additionally, death benefits received by a C corporation may subject the corporation to the Alternative Minimum Tax.

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